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Erosion of "Subtle Hazards" Analysis Jeopardizes Safety and Soundness of the Banking System: Securities Industry Association v. Board of Governors (NATWEST)

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Erosion of "Subtle Hazards" Analysis Jeopardizes Safety and Soundness of the Banking System: *Securities Industry Association v. Board of Governors (NATWEST)* — The Glass-Steagall Act — the popular name for sections 16, 20, 21 and 32 of the Banking Act of 1933[1] — traditionally has operated as a barrier between commercial and investment banking.[2] Congress enacted Glass-Steagall in response to perceived widespread abuses by commercial banks involved in securities activities.[3] The public saw these activities, as did Congress, as a primary cause of the stock market crash of 1929 and its accompanying bank failures.[4] By restricting commercial banks to the business of commercial banking, Congress sought to restore public confidence in the banking system.[5]

The most significant policy rationale underlying Glass-Steagall is the safety and soundness of the banking system.[6] Congress en-

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[1] 12 U.S.C. §§ 24 (Seventh), 78, 377, 378 (1982 & Supp. III 1985).

[2] Commercial banks are organizations which fall into one of four categories. National banks are chartered, inspected and regulated by the Comptroller of the Currency. Such banks are required to be insured members of the Federal Reserve System (FRS). State member banks are regulated by the state in which they operate. As FRS members, they are regulated by the FRS, and are required to be insured. Insured, non-member banks have all the characteristics of state member banks, but are not part of the FRS. Non-insured, non-member banks are state regulated, but do not belong to the FRS. For an overview of various bank classifications and their regulatory structure, see Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 3–23 (1977).

Though commercial bank activities are continually evolving, the Supreme Court description of commercial banks as institutions "that receive deposits subject to repayment, lend money, discount and negotiate promissory notes and the like" remains a valid one. Investment Co. Inst. v. Camp, 401 U.S. 617, 629 (1971); *see also* 12 U.S.C. § 24 (Seventh). Section 24 empowers banks to "carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidence of debt; by receiving deposits, by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes . . . ."

In contrast, investment banking firms offer such services as brokerage, securities underwriting, advisory services, merger and acquisition assistance and mutual fund management. Note, *Restrictions on Bank Underwriting of Corporate Securities: A Proposal for More Permissive Regulation*, 97 HARV. L. REV. 720–21 n.9 (1984).

[3] *See* Norton, *Up Against "the Wall": Glass-Steagall and the Dilemma of a Deregulated ("Reregulated") Banking Environment*, 42 BUS. LAW. 327, 327 (1987).

[4] *See* Ianni, *"Security" Under the Glass-Steagall Act and the Federal Securities Acts of 1933 and 1934: The Direction of the Supreme Court's Analysis*, 100 BANKING L.J. 100, 103–05 (1983).

[5] Norton, *supra* note 3, at 327. The separation between commercial and investment banking was not a new development in 1933, but rather was part of the financial structure the United States inherited from Great Britain. In some countries, such as France and Germany, commercial and investment banking activities are largely combined. Fischer, Gram, Kaufman & Mote, *The Securities Activities of Commercial Banks: A Legal and Economic Analysis*, 51 TENN. L. REV. 467, 469 (1984) [hereinafter, Fischer].

[6] *See* Plotkin, *What Meaning Does Glass-Steagall Have For Today's Financial World?*, 95 BANKING L.J. 404, 407 (1978).

acted Glass-Steagall because many legislators believed that commercial bank ventures in the securities field created the potential for practices that could undermine the system.[7] The United States Supreme Court, upon examining Glass-Steagall's legislative history, found that Congress sought not only to prevent banks from investing their own assets imprudently in securities, but also to prevent the more "subtle hazards" that arise when commercial banks enter the investment banking business.[8]

The Court also gleaned from Glass-Steagall's legislative history that Congress considered that the policy of furthering competition might favor commercial bank entry into investment banking.[9] Congress, however, stated the Court, determined that the potential for financial dangers outweighed other policy considerations.[10] Commercial banks are the focus of such heightened concern for safety and soundness because they play a fundamental role in the economy.[11] Realizing that banks were "special," Congress imposed protectionary measures to ensure that the institutions remained capable of supplying their unique services.[12] Legislators and regulators impose operational restrictions on banks in the belief that preventing

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[7] *See Camp*, 401 U.S. at 629–30; *see also* Ianni, *supra* note 4, at 103–04.

[8] *Camp*, 401 U.S. at 630. The Court stated:

> The hazards that Congress had in mind were not limited to the obvious danger that a bank might invest its own assets in frozen or otherwise imprudent stock or security investments .... The legislative history of the Glass-Steagall Act shows that Congress also had in mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments.

Id.

[9] *Id.* at 636. The court stated: "From the perspective of competition, convenience, and expertise, there are arguments to be made in support of allowing commercial banks to enter the investment banking business." *Id.*

[10] *Id.* at 630. The Court stated:

> The Glass-Steagall Act reflected a determination that policies of competition, convenience or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the "hazards" and "financial dangers" that arise when commercial banks engage in the activities proscribed by the Act.

Id.

[11] *See* C. Golembe & D. Holland, Federal Regulation of Banking 1986–87, 275 (1986).

[12] DiLorenzo, *Public Confidence in the Banking System: The Policy Basis for Continued Separation of Commercial and Investment Banking*, 35 Am. U.L. Rev. 647, 655 (1986). The author noted that the policy behind the protective environment is a justification for governmental restrictions on permissible bank activities. *Id.*

individual banks from experiencing financial difficulty will keep the monetary system stable.[13]

Safety and soundness considerations in banking regulation are vital because depository institutions are conduits of money and suppliers of credit in the economy.[14] The Federal Reserve attempts to maintain a stable money supply by controlling the quantity of money in the economy.[15] Banks, in their intermediary capacity, receive demand deposits and invest or loan that money to other parties.[16] The money a bank loans out is deposited in another bank, and that bank then has new money to loan or invest.[17] This is how banks are said to "create" money. The complexities of the payment system, which include check clearing and electronic funds transfers, also make the safety and soundness of banks essential.[18] The monetary function of banks is affected with the public interest, and thus banks have been regulated much like public agencies.[19]

Banks are also vital to the economy as suppliers of credit.[20] Congress has kept commercial and investment banking separate not only to maintain safety and soundness, but also to assure neutrality in the granting of credit to competing borrowers in society.[21] If

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[13] *Id.* at 51.

[14] *See* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS 1–2 (7th ed. 1985) [hereinafter PURPOSES & FUNCTIONS].

[15] See *id.* at 13–15 for an overview of how the Federal Reserve implements monetary policy by controlling the money supply; *see also* Smith, *The Instruments of General Monetary Control*, in MONEY, BANKING, AND MONETARY POLICY: READINGS IN DOMESTIC AND INTERNATIONAL POLICY 200 (H. Williams & H. Woudenberg eds. 1970). According to Smith, the Federal Reserve System utilizes three main instruments of monetary control: the power to purchase and sell securities on the open market; the ability to fix discount rates and regulate member bank borrowing in other ways; and the authority to alter reserve requirements of member banks. *Id.*

[16] *See* E. SYMONS, JR. & J. WHITE, BANKING LAW TEACHING MATERIALS 50 (2d ed. 1984).

[17] *Id.*

[18] *See generally* PURPOSES & FUNCTIONS *supra* note 13, at 105–10; *see also* Haywood, *Regulation, Structure, and Technological Change in the Consumer Financial Services Industry*, in REGULATION OF CONSUMER FINANCIAL SERVICES 163, 163–67 (A. Heggestad ed. 1981) for an interesting discussion of the impact that the regulatory structure and technological changes in the financial services industry have on one another. According to Haywood, "[o]ver the past thirty years, the production and distribution of financial services has been significantly affected by technological improvements in data processing, communications, transportation, and organization, as well as by innovations in financial services and instruments. *Id.* at 163.

[19] Shull, *The Separation of Banking and Commerce: Origin, Development, and Implications for Antitrust*, 28 ANTITRUST BULL. 255, 271 (1983); *see also* DiLorenzo, *supra* note 12, at 658. DiLorenzo noted that the regulatory structure imposed on banks was intended to bolster public confidence and avoid the widespread withdrawal of deposits.

[20] *See* GOLEMBE & HOLLAND, *supra* note 11, at 275.

[21] *See* SYMONS, JR. & WHITE, *supra* note 16, at 172.

banks did not grant credit neutrally, it could disrupt the natural forces of the private economic system.[22]

Congress and regulators achieve a safe and sound banking system in part through efforts to prevent bank failures.[23] Because of its credit and monetary functions, a commercial bank's failure can disrupt the economy.[24] A bank failure may also damage a risk-sensitive public's confidence in the banking system.[25] It is essential that the public perceive banks as safe institutions in which to deposit funds, for if banks could not attract deposits, then the Federal Reserve would be unable to utilize banks in its efforts to stabilize the economy.[26] In separating commercial from investment banking, the framers of Glass-Steagall reacted to the bank failures of their era.[27] With bank failures on the upswing since 1982, regulators and legislators again are focusing attention on this problem.[28]

Safety and soundness considerations are aimed at protecting the integrity of the system.[29] Only recently has Congress enacted consumer protection laws relating to individual depositors.[30] Before that, regulators relied upon competition among financial institutions to assure fair prices and convenient services for the public.[31] Maintaining a reasonably competitive market especially helps to mobilize credit.[32]

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[22] *Id.*

[23] *See* GOLEMBE & HOLLAND, *supra* note 11, at 10.

[24] *See id.* at 8; *see also* DiLorenzo, *supra* note 12, at 648. According to DiLorenzo, public confidence in banking should be the focus of the policy debate over whether to maintain separation between commercial and investment banking. The author stated that analyzing the problem with public confidence in mind "leads to the conclusion that unwaivering separation of commercial and investment banking is the wisest course of action for Congress and the courts." *Id.*

[25] *See generally* Perkins, *The Divorce of Commercial and Investment Banking: A History,* 88 BANKING L.J. 483, 497 (1971).

[26] *See supra* notes 15–19 and accompanying text for a discussion of the monetary system.

[27] *See* Ianni, *supra* note 4, at 103–05.

[28] *See* Moskowitz, *Why Banks Fail,* 11 BUS. & SOCIETY REV. 53, 53–55 (1988). In 1982 there were forty-two commercial bank failures in the United States, while in 1987 there were one-hundred-eighty-four failures. *Id.* at 54. Moskowitz pointed out that banks still fail the "old-fashioned way." That is, they fail through managerial incompetence and director neglect. *Id.* at 55. Moskowitz listed a number of factors that lead to bank failures, such as uninformed bank directors, poor loan policies, inadequate systems to ensure compliance with bank laws and internal policies, overly-aggressive and excessively growth-minded directors and managers, and insider abuse and fraud. *Id.*; *see also* GOLEMBE & HOLLAND, *supra* note 11, at 116.

[29] *See generally id.* at 276.

[30] *Id.* at 81.

[31] *Id.* at 91.

[32] *Id.* at 275.

Promoting competition in the financial services industry, however, conflicts to some extent with maintaining a safe and sound banking system.[33] It is natural in a competitive market that the more efficient actors drive the less efficient ones out of business.[34] Thus, when regulators, legislators or the courts decide to increase commercial bank competitiveness, they infringe on the safety and soundness consideration of preventing bank failures.[35] As the Supreme Court noted, Congress emphasized the importance of safety and soundness above a policy of competition in enacting Glass-Steagall.[36]

Regulators and the judiciary alike heard little debate over Glass-Steagall for the first thirty years of its existence.[37] Rapid changes in the financial industry, however, including the expansion of thrift institution services,[38] the appearance of bank holding companies,[39] and inflation and high interest rates, catapulted financial institutions into a more competitive environment.[40] As a result of Glass-Steagall's restraints on commercial banks, investment banks and other intermediaries came forth to fill the void.[41] Investment banks offered many new products, and also offered products that resembled traditional commercial banking services such as deposit-type securities and consumer credit cards.[42] The growth of a global economy also served to heighten competition on the international level.[43] In this atmosphere, commercial banks became more aggressive in their pursuit of securities-related profits traditionally associated with investment banking.[44] Thus, the prohibitions Glass-Steagall placed

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[33] *See* SYMONS, JR. & WHITE, *supra* note 16, at 80.

[34] *Id.*

[35] *See id.*

[36] *Camp*, 401 U.S. at 630.

[37] Norton, *supra* note 3, at 334.

[38] Savings banks, savings and loans associations and credit unions are often called "thrifts." These institutions have operated for many years as depository institutions. Thrifts, however, have been given authority to issue the equivalent of checking accounts and have become multi-purpose lenders. *See* GOLEMBE & HOLLAND, *supra* note 11, at 9–11.

[39] For purposes of the Bank Holding Company Act of 1956 (as amended 1970), a bank holding company is any company that directly or indirectly owns or controls, with power to vote, more than five percent of the voting shares of each of one or more banks. 12 U.S.C. § 1841(a)(1982).

[40] Note, *Glass-Steagall: A Proposal for Regulation Rather Than Prohibition*, 47 ALB. L. REV. 1378, 1378 (1983).

[41] Fischer, *supra* note 5, at 470.

[42] *Id.*

[43] *See* Woody, *The International Implications of Deregulating the U.S. Banking Industry*, 31 AM. U.L. REV. 25, 25–26 (1981).

[44] *See* Phelps & Spedale, *Reinterpreting Glass-Steagall: A Bank's Move Into Brokerage*, 122 TR. & EST. 17, 17 (Nov. 1983).

upon bank securities activities became the focus of increased litigation.[45]

In recent years banks have been successful in petitioning the regulators and the courts to expand the types of securities activities that banks may undertake.[46] One organization displeased over such developments is the Securities Industry Association (SIA), a trade association of underwriters, brokers and securities dealers.[47] SIA seeks to protect its securities domain from further commercial bank encroachment.[48] Many of SIA's arguments against securities activity by commercial banks are based upon notions of safety and soundness.[49]

A 1987 decision by the United States Court of Appeals for the District of Columbia Circuit, *Securities Industry Association v. Board of Governors (NatWest)*,[50] holding that a bank's subsidiary could offer both discount brokerage[51] and investment advice[52] to its customers, fueled the Glass-Steagall debate over the separation of banking and securities. By permitting such a combination of services, the *NatWest* court narrowed Glass-Steagall's limitations further than previous decisions.

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[45] See *infra* notes 93–162 and accompanying text for a discussion of cases interpreting Glass-Steagall.

[46] *See infra* notes 123–43, 154–162, 172–218 and accompanying text;*see also* DiLorenzo, *supra* note 12, at 678. The author maintained that advocates of joining commercial and investment banking should have the burden of showing that the combination of activities would result in public advantages that significantly override any risk of loss.

[47] See Securities Industry Association, *Bank Securities Activities: Memorandum for Study and Discussion*, 14 SAN DIEGO L. REV. 751 (1977), for the group's position on the appropriateness of bank-sponsored securities activities.

[48] *See id.* at 758–59. SIA commented:

> Because of their importance as financial intermediaries, banks have been accorded a variety of privileges designed to reduce their costs of intermediation .... [I]t would be highly unfair to expect non-banking entities to compete with banks in businesses other than banking without the benefit of such privileges.

Id.

[49] *Id.* at 790–91.

[50] 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 108 S. Ct. 697 (1988).

[51] *See* Note, *A Banker's Adventures in Brokerland: Looking Through Glass-Steagall at Discount Brokerage Services*, 81 MICH. L. REV. 1498, 1498 (1983). Discount brokerage dates from the elimination of fixed brokerage commissions in 1975. Though the term "discount brokerage" has no single definition, its focus is on executing client-initiated orders. By acting only as agents, discount brokers can charge much lower rates than full-service brokers who, typically, employ research staffs, offer investment advice and deal in securities for their own accounts. *Id.* at 1498–99.

[52] The Investment Company Act of 1940 defines an investment advisor as any person who, directly or through publications, and for compensation, advises others as to the value of securities or as to the advisability of buying or selling securities. 15 U.S.C. §§ 80a–2(20)(1982).

This casenote examines *NatWest* in light of its place in the continuing debate over the separation of commercial and investment banking, paying special attention to the conflicting policies involved. Section I examines Glass-Steagall's legislative history and judicial interpretation of its provisions.[53] Section II delineates the reasoning of the *NatWest* opinion.[54] Section III analyzes the court's reasoning, including its implicit policy choices.[55] This casenote concludes that the *NatWest* court's expansive view of commercial bank powers in the securities area represents a potentially dangerous determination that a policy of strengthening the competitive position of banks is more important than a safe and sound banking system.

I. Growth of the Glass-Steagall Debate

Congress enacted the Banking Act of 1933 as a piece of emergency legislation during the first one hundred days of the New Deal.[56] Congress developed the Glass-Steagall provisions in response to commercial bank abuses in the securities field.[57] The Act's legislative history indicates that congressional leaders believed banks to have a fiduciary obligation to their depositors.[58] The congressional viewpoint arose from a recognition that banks' operational funds did not flow from equity markets, but from depositors' savings.[59] One particular abuse of depositor funds that heightened public opinion against the securities affiliate system was the failure of the Bank of the United States in December 1930.[60] Causing the failure was the bank president's appropriation of bank funds for his own speculative investments. When the bank finally closed its doors, the bank had over $200 million of deposits, many belonging to immigrants who falsely believed that the bank's name meant that it was

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[53] *See infra* notes 56–170 and accompanying text.

[54] *See infra* notes 172–218 and accompanying text.

[55] *See infra* notes 219–45 and accompanying text.

[56] Perkins, *supra* note 25, at 483.

[57] Comment, *Federal Regulation Securities Activities: Will Congress Allow Glass-Steagall to be Shattered*?, 12 J. Contemp. L. 99, 99–100 (1986).

[58] DiLorenzo, *supra* note 12, at 655. Congressman Steagall, who co-sponsored the Glass-Steagall Act, stated that the "purpose of this legislation is to protect the people of the United States in the right to have banks in which their deposits will be safe." 77 Cong. Rec. 3,837 (1933). Steagall also stated that citizens should be able to "place their hard earnings" in banks "with reasonable expectation of being able to get them out again upon demand." *Id.*

[59] DiLorenzo, *supra* note 12, at 655.

[60] Perkins, *supra* note 25, at 496-97.

connected to the national government.[61] Legislators blamed this and other such wrongdoings for the financial collapse leading to the Depression.[62]

Although Glass-Steagall placed a formidable barrier between commercial and investment banking, there remained some accepted overlap.[63] For example, commercial banks are permitted to buy and sell securities on the order of their customers, to underwrite certain government obligations and to purchase investment securities for their own accounts.[64] Trust department activities are another example of commercial banks' power to perform certain securities functions.[65]

Prior to the enactment of Glass-Steagall, state banks directly sold and underwrote securities, while some national banks set up affiliates through which to perform such activities.[66] In the late 1920s, due to a decline in loan demand, commercial banks intensified their securities efforts as an alternative profit source.[67] By 1930 commercial banks and their affiliates dominated the investment banking field.[68]

After the stock market crash of 1929 and its accompanying bank failures, congressional investigations revealed that some commercial banks utilized depositors' funds directly in securities transactions.[69] Congress uncovered such abuses as the extension of unsound loans and the dissemination of biased investment advice in order to bolster securities in which banks had an investment.[70] Unsound loans also went to securities affiliates of commercial banks.[71] The public became aware of certain securities-related

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[61] *Id.*

[62] Board of Governors v. Investment Co. Inst. (ICI), 450 U.S. 46, 63 (1981).

[63] Norton, *supra* note 3, at 327; *see also* Fischer, *supra* note 5, at 469. The authors noted that "[c]ommercial banks have engaged in some securities activities throughout virtually their entire history. The particular type of activity has changed through time depending upon federal and state legislatures, the courts, and . . . the extent to which banks are aggressive and innovative . . . . " *Id.*

[64] 12 U.S.C. § 24 (Seventh).

[65] *See* Comment, *Fiduciary Duty of Bank Trust Departments: Whose Profit is it Anyway?*, 5 ANN. REV. BANKING L. 335, 339 (1986). At common law, the most fundamental fiduciary duty of a fiduciary was to maintain complete loyalty to the beneficiary. Traditionally, courts adhered to a no self-dealing rule, rejecting arguments that a trustee should be able to keep profits made at the expense of a beneficiary. *Id.*

[66] *See* Perkins, *supra* note 25, at 488–89.

[67] *Id.* at 493.

[68] *Id.* at 495.

[69] Note, *supra* note 40, at 1381–82.

[70] *Id.* at 1382.

[71] *Id.*

abuses involving affiliates.[72] In this atmosphere of public mistrust of affiliates involved with investment activity, Senator Glass pushed through his effort to separate commercial from investment banking.[73]

Congress sought to implement three main objectives in passing Glass-Steagall.[74] First, Congress intended to restore public confidence in banking following the financial disasters connected with the Depression.[75] Second, Congress sought to increase the neutrality of advice a bank gives its customers by avoiding potential conflicts of interest between commercial and investment banking operations.[76] Finally, Congress intended to protect and maintain the financial soundness of commercial banking by preventing unsound and imprudent investment.[77]

The Act's framers recognized the traditional notion that commercial and investment banking were separate activities. Glass-Steagall defines commercial banking to include making loans and taking deposits.[78] Glass-Steagall defines investment banking as "the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes or other securities . . . ."[79] Commercial banking is distinct from investment banking because an investment generally is of a more permanent nature, and credit in the form of stocks and bonds is of a longer duration. Also, a deposit with an investment bank is a special deposit for a particular purpose, which differs from a general deposit. Thus, the relationship an investment bank establishes with its customers resembles agency more than the usual creditor-debtor relationship involved in commercial banking.[80]

Four major sections of Glass-Steagall govern the relationship between banking and securities.[81] In general, these provisions cre-

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[72] *See* Perkins, *supra* note 25, at 496–97.

[73] See *id.* at 497–526 for a discussion of Glass's efforts to separate commercial from investment banking.

[74] *See* Comment, *supra* note 57, at 105.

[75] *See* Plotkin, *supra* note 6, at 407.

[76] *Id.*; *see also* Hunsicker, *Conflicts of Interest, Economic Distortions, and the Separation of Trust and Commercial Banking Functions*, 50 S. CAL. L. REV. 611 (1977). Information made available to the bank's commercial loan department could aid a bank's trust department or securities affiliate in its investment decisions. *Id.* at 630–31.

[77] Plotkin, *supra* note 6 at 407.

[78] SYMONS, JR. & WHITE, *supra* note 16, at 434.

[79] *Id.*

[80] *Id.*

[81] 12 U.S.C. § 24 (Seventh), 78, 377, 378.

ated a barrier between commercial and investment banking.[82] Section 16 of Glass-Steagall limits member bank securities transactions to those carried out for the accounts of bank customers.[83] Section 20 prohibits member banks from affiliating with organizations "engaged principally" in the investment banking business.[84] Glass-Steagall's section 21 prohibits securities dealers from accepting deposits.[85] The final provision of Glass-Steagall, section 32, proscribes interlocking managements between member banks and firms "primarily engaged" in the securities business.[86]

Because Glass-Steagall applies only to banks, its provisions could be avoided by organizations that formed bank holding companies.[87] By the early 1950s many banks became involved in activities prohibited by Glass-Steagall by organizing into bank holding

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[82] Norton, *supra* note 3, at 334.

[83] Section 16 of Glass-Steagall is codified at 12 U.S.C. § 24 (Seventh), which provides in pertinent part that:

> The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the orders and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issues of securities of stock; Provided, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. . . . The limitations and restrictions herein contained as to dealing in, underwriting, and purchasing for its own account investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof . . . .

[84] Section 20 of Glass-Steagall is codified at 12 U.S.C. § 377, which provides in pertinent part that:

> No member bank shall be affiliated in any manner described in . . . this title with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . . .

[85] Section 21 of Glass-Steagall is codified at 12 U.S.C. § 378, which provides in pertinent part that it is unlawful for:

> any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling or distributing . . . securities, to engage at the same time to any extent whatever in the business of receiving deposits . . . .

[86] Section 32 of Glass-Steagall is codified at 12 U.S.C. § 78, which provides in pertinent part that:

> No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution . . . of securities, shall serve at the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations . . . .

[87] *See* Board of Governors v. Investment Co. Inst. (ICI), 450 U.S. 46, 58 n.24 (1981).

companies.[88] To address this problem, Congress enacted the Bank Holding Company Act of 1956 (BHCA).[89] Congress intended BHCA to prevent undue concentrations of resources and to protect against unsafe connections between banks and other non-banking ventures, including securities activities.[90] The 1956 version of BHCA applied only to companies holding two or more banks.[91] Congress strengthened its control over bank holding companies by amending BHCA in 1970 to include one-bank holding companies.[92] Thus, by 1970 all bank holding companies moved under the umbrella of safe and sound banking.

Cases interpreting Glass-Steagall illuminate the policy considerations at stake in the separation between banking and securities. The first case to interpret Glass-Steagall was the 1947 case of *Board of Governors v. Agnew*,[93] in which the Supreme Court upheld a Board of Governors of the Federal Reserve System (Board) decision to remove bank directors who were also employed by a firm "primarily engaged" in securities underwriting.[94] In *Agnew*, directors of a national bank also maintained employment at a securities firm, which the directors claimed was not "primarily engaged" in underwriting activity because less than fifty percent of its income was derived in that manner. The *Agnew* Court stated that underwriting needed only to be a "substantial" activity of a firm to bring it under Glass-Steagall's section 32, not the chief or principal activity.[95]

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[88] Note, *Avoiding the Glass-Steagall and Bank Holding Company Acts: An Option for Bank Product Expansion*, 59 IND. L.J. 89, 106 (1983).

[89] 12 U.S.C. §§ 1841–1850 (1982 & Supp. III 1985).

[90] *See id.* § 1843(c)(8). In hearings on the BHCA Amendments of 1970, the Chairman of the Federal Reserve Board stated:

> Considerations of safety and soundness reinforce the policy of separating banking and other businesses. A bank should be insulated from pressures that might lead it to favor customers of affiliated businesses in its credit decisions. Otherwise, the bank might build an unbalanced loan portfolio by discounting an excessive amount of obligations of such customers, or a low-quality portfolio by accepting substandard risks to foster sales to such customers. An essential part of the traditions of bank management has been a scrupulous observance of the need for prudence in handling funds entrusted to the bank by its customers; if management were to become oriented toward the different objectives of other businesses, this tradition could be seriously weakened.

Hearings on H.R. 6778 before the House Comm. on Banking and Currency, 91st Cong., 1st Sess. 197 (1969)(statements of William McChesney Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System).

[91] *See* Note, *supra* note 88, at 94.

[92] *Id.*

[93] 329 U.S. 441 (1947).

[94] *Id.* at 446.

[95] *Id.*

In deciding the case, the *Agnew* Court looked back to the practices of the 1920's in which a bank director interested in the underwriting business might wield his or her influence in the bank to involve it in securities in which his or her underwriting firm had an investment.[96] The likelihood of such a scenario repeating itself, the court stated, did not depend on whether the underwriting activity exceeded a certain percentage of its business.[97] The *Agnew* Court noted that Congress intended Glass-Steagall as a "prophylactic measure" against potential conflicts of interest.[98] The decision thus demonstrated the Court's early willingness to enforce strictly the separation of commercial and investment banking created by Glass-Steagall.

Twenty-four years after *Agnew*, in *Investment Co. Institute v. Camp*, the Supreme Court continued to maintain the barrier between banking and securities.[99] The *Camp* Court held that open-end collective investment funds of the type proposed were like mutual funds, the sale of which was forbidden by section 16 of Glass-Steagall.[100] The Court concluded that allowing a bank to manage a collective investment fund as an investment advisor would violate the congressional intent in passing Glass-Steagall.[101]

The *Camp* decision is significant for its detailed discussion of the policies underlying Congress's enactment of Glass-Steagall.The "subtle hazards"[102] analysis set forth by the *Camp* Court remains an essential component of judicial interpretation of Glass-Steagall.[103] According to the Court, Congress believed that the promotional pressures of investment banking and the investment banker's pecuniary stake in the success of a particular investment opportunity endangered safe, sound and disinterested commercial banking practices.[104] Such hazardous activities, explained the Court, could destroy public confidence in the banking system.[105] The *Camp* Court

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[96] *Id.* at 447.
[97] *Id.*
[98] *Id.* at 449.
[99] 401 U.S. 617 (1971).
[100] *See id.* at 639, 624–25.
[101] *Id.* at 639.
[102] See *supra* note 8 for a statement of the subtle hazards.
[103] See *infra* note 210 and accompanying text.
[104] *Camp*, 401 U.S. at 634.
[105] *Id.*; *see also* DiLorenzo, *supra* note 12, at 661 n.60. A survey by Reichman Research, Inc. revealed several factors that could impair public confidence in the banking system. In order of significance they were: (1) the failure of many banks (2) economic instability; (3) an abundance of money loaned to foreign countries; (4) high interest rates on loans; and (5) bank incompetence and poor management. *Id.*

stated that Glass-Steagall represented a Congressional determination that the hazards associated with commercial bank entry into investment banking outweighed any possible competitive benefits.[106]

The Court concluded that Congress sought to avoid the obvious danger that a bank might unwisely invest its own assets in securities.[107] The Court also noted, however, that Congress focused its attention on the potential for subtle hazards. These hazards, the Court stated, arise when a commercial bank goes beyond the business of acting as a managing agent or as a fiduciary, and enters investment banking directly or establishes affiliates to deal in securities.[108]

The *Camp* Court outlined a number of subtle hazards.[109] The Court noted that entering the investment banking business places new "promotional and other pressures" on a commercial bank, thus leading to certain "temptations."[110] According to the Court, when a bank and its affiliate are linked in the public mind and the affiliate does not perform satisfactorily, the public will lose confidence in the bank.[111] The Court postulated that because public confidence is necessary for bank solvency, the natural temptation for a bank might be to support the affiliate through unsound loans.[112] The *Camp* Court further noted that the pressure to sell a particular investment and to bolster an affiliate might tempt the bank to make its credit facilities more readily available to companies in which the affiliate had invested. The Court shared Congress's fear that a bank's salesperson's interest might impair its ability to operate as an unbiased credit source.[113]

According to the *Camp* opinion, another subtle hazard Congress foresaw was that bank depositors might suffer losses made on investments made in reliance on the connection between the bank and its affiliate.[114] The consequent loss of customer goodwill, the Court noted, might damage the particular bank's reputation and ability to perform well in a deflated securities market.[115] Congress

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[106] *Id.* at 630.
[107] *Id.*
[108] *Id.*
[109] *Id.* at 630–38.
[110] *Id.* at 630–31.
[111] *Id.* at 631.
[112] *Id.*
[113] *Id.* See *supra* notes 22–23 and accompanying text for a discussion of neutrality in credit-granting.
[114] 401 U.S. at 631.
[115] *Id.*

believed, the *Camp* Court explained, that it would be improper for banks to lend their reputations for "prudence and restraint" to the business of inherently risky securities affiliates.[116] The Court also pointed out Congress's concern that banks might be tempted to provide loans to customers to enable them to purchase securities.[117] According to the Court, Congress sought to prevent commercial banking facilities and talent from being diverted into speculative activities.[118]

The *Camp* Court listed conflicts between the promotional interest of the investment banker and the commercial banker's duty to render unbiased investment advice as another subtle hazard Congress contemplated.[119] Congress collected evidence indicating that security affiliates might unload excessive holdings through the bank's trust department. Such activity, the Court noted, might constitute self-dealing and violate a trustee's fiduciary duty.[120]

The Court contrasted the traditional services commercial banks provided with those offered by investment banks and found that subtle hazards are not present when a bank purchases stock for its customers' accounts or commingles assets that it handles in a fiduciary capacity.[121] Such activities, the Court stated, unlike the operation of an investment fund, do not give rise to a "salesman's stake" in a particular investment because they do not cause a bank to compete with funds promoted by other investment companies, do not weaken public confidence in banking, and do not affect a bank's ability to advise a customer disinterestedly. The Court thus concluded that there was a "plain difference" between selling investments and selling fiduciary services.[122]

Ten years after *Camp*, in 1981, in *Board of Governors v. Investment Co. Institute (ICI)*, the Court upheld a regulation that permitted a bank holding company and its non-bank subsidiary to act as an investment advisor to a closed-end investment company.[123] ICI challenged the Board's amendment to Regulation Y,[124] an amendment that enlarged the categories of activities it would regard as "closely

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[116] *Id.* at 631–32.

[117] *Id.* at 632.

[118] *Id.*

[119] *Id.* at 633.

[120] *Id.*

[121] *Id.* at 638.

[122] *Id.*

[123] 450 U.S. 46, 78 (1981).

[124] 12 C.F.R. § 225. The regulation includes a list of permissible non-banking activities in which bank holding companies may participate directly or through an affiliate. *Id.*

related" to banking under BHCA.[125] The Board issued an interpretive ruling that distinguished the open-end investment companies prohibited in *Camp* from the closed-end investment companies allowed under Regulation Y.[126] The Board believed, and the *ICI* Court agreed, that a bank subsidiary could offer closed-end funds without violating Glass-Steagall's section 20.[127]

In upholding the regulation, the Court explained that Congress intended BHCA to maintain and strengthen Glass-Steagall's separation between commercial and investment banking.[128] In fact, the Court noted, the 1956 version of BHCA operated to close a loophole that bank holding companies had been using to avoid Glass-Steagall restrictions.[129] Although *ICI* represented a more expansive view of permissible securities activities by banks, the Court reiterated the notion that Glass-Steagall and BHCA work together to maintain a division between commercial and investment banking.

In 1984, three years after *ICI*, in *Securities Industry Association v. Board of Governors (Schwab)*,[130] the Supreme Court upheld another Board decision allowing a bank holding company to acquire a nonbank affiliate engaged principally in discount securities brokerage.[131] The Board determined, and the Court agreed, that banks' use of sophisticated resources and techniques to execute buy and sell orders for customers was widespread enough to support a find-

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[125] BHCA's general ban on bank holding company ownership or control of non-banking entities does not apply to the following:

> shares of any company the activity of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto . . . . In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse affects, such as undue concentrations of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

12 U.S.C. § 1843(4)(c)(8).

[126] The Board explained that an "open-end" investment company or "mutual fund" differs from a closed-end investment company. An open-end company is typically engaged on a continuous basis in issuing its shares and stands ready to redeem the securities. A closed-end company typically does not issue shares after its initial organization, except on infrequent occasions, and does not stand ready to redeem its shares. 12 C.F.R. § 225.125(c).

[127] 450 U.S. at 78.

[128] *Id.* at 69.

[129] *Id.* at 70.

[130] 468 U.S. 207 (1984).

[131] *Id.* at 221.

ing that banks are sufficiently equipped to provide such services.[132] The Court shared the Board's view that traditional trust services were identical to the services offered by Schwab. The Board held, and the Court agreed, that Schwab's business of offering discount brokerage, without the provision of investment advice, was "closely related" to banking within the meaning of BHCA.[133]

The Court acknowledged that section 20 of Glass-Steagall prohibits member banks from affiliating with any corporation "engaged principally in the issue, flotation, underwriting, public sale or distribution" of securities.[134] The *Schwab* Court stated that the term "public sale" should be read in conjunction with its surrounding terms.[135] Discount brokerage, the Court observed, did not fall within the definition of "public sale."[136] Schwab, the Court stated, would not engage in those activities normally associated with the underwriting activities enumerated in section 20.[137] This was so, the Court explained, because while an underwriter usually acted as a principal, a broker executed orders as an agent.[138]

Although the *Schwab* Court held that discount brokerage was not within the literal terms of Glass-Steagall, it nonetheless considered the subtle hazards analysis.[139] The Court maintained that none of the subtle hazards would be implicated by discount brokerage services.[140] The Court reasoned that because Schwab traded as an agent, its assets were not subject to the vagaries of the securities markets.[141] Schwab's profits, the Court stated, were dependent on the volume of shares traded and not on the purchase or sale of particular securities. Thus, the Court concluded, the affiliated bank would have no "salesman's stake" in the securities Schwab traded.[142]

The *Schwab* decision demonstrated that the judiciary was willing to accept some erosion of the Glass-Steagall barrier between banking and securities. The Court viewed discount brokerage, although a securities-related activity, as the same type of service that banks

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[132] *Id.* at 212.
[133] *Id.*
[134] *Id.*
[135] *Id.* at 217–18.
[136] *Id.* at 221.
[137] *Id.* at 217.
[138] *Id.* at 217–18.
[139] *Id.* at 220–21.
[140] *Id.* at 220.
[141] *Id.*
[142] *Id.*

could already provide through their trust departments.[143] The decision, while expanding bank powers in the securities area, nonetheless continued to monitor the potential subtle hazards.

In a decision handed down the same day as *Schwab*, *Securities Industry Association v. Board of Governors (Bankers Trust I)*,[144] the Supreme Court held that commercial paper was a "security" within Glass-Steagall.[145] The *Bankers Trust I* Court noted that the term "security" should be construed broadly.[146] The Court further maintained that the Board's analysis, which concluded that commercial paper did not function as a security and therefore was not within Glass-Steagall's proscriptions, failed to comprehend Congress's concerns over commercial bank relationships with securities marketing.[147]

The Court did not agree with the Board that subtle hazards were not implicated in the marketing of commercial paper.[148] The Court found that in the commercial paper market, where the distribution of an issue depended upon the credit-worthiness of an issuer, a bank could enhance an issue's marketability by giving the issuer backup credit.[149] Also, the Court added, a bank competing against other commercial paper dealers could feel pressure to buy unsold notes to boost its own reputation, even where the paper did not meet the bank's usual credit standards. The *Bankers Trust I* Court also found that a bank's commercial paper dealings could implicate such other subtle hazards as conflicts of interest and loss of depositor goodwill.[150] The Court pointed out that Glass-Steagall's prophylactic prohibition of underwriting demonstrated Congress's determination that the mere existence of a securities operation, no matter how carefully run, was inconsistent with a bank's best interests.[151]

The *Bankers Trust I* Court remanded the case to the United States Court of Appeals for the District of Columbia Circuit to

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[143] *Id.* at 212.

[144] 468 U.S. 137 (1984).

[145] *Id.* at 139. Commercial paper is first quality, unsecured, short-term promissory notes issued by large corporations to fund activities. Note, *Security Under the Glass-Steagall Act: Analyzing the Supreme Court's Framework for Determining Permissible Bank Activities*, 70 CORNELL L. REV. 1194, 1194 (1985).

[146] *Bankers Trust I*, 468 U.S. at 150.

[147] *Id.* at 154.

[148] *Id.* at 155.

[149] *Id.*

[150] *Id.* at 156.

[151] *Id.* at 157.

determine whether commercial paper placement constituted the type of underwriting Glass-Steagall prohibits.[152] In *Securities Industry Association v. Board of Governors (Bankers Trust II)*,[153] the court of appeals held that Bankers Trust's placement of commercial paper constituted a "sale" of securities, but was permissible under Glass-Steagall's section 16.[154] The court so held because the sale of securities would be executed without recourse and solely upon the order and for the account of customers.[155]

The court ruled that, with one exception, Bankers Trust's activities would not implicate subtle hazards.[156] The Board had argued, the court noted, that because commercial paper buyers are sophisticated business entities, they would be unlikely to blame a bank for what really amounted to their own error in judgment. Thus, any resulting harm would not affect the bank's public reputation.[157]

The *Bankers Trust II* court, though agreeing with the Board's discussion of sophisticated business customers, was bound to follow the finding of the Supreme Court that the subtle hazard of loss of reputation did exist.[158] The court, however, maintained that this loss was not sufficient to prohibit Bankers Trust from placing commercial paper.[159] The court delineated a number of reasons for this conclusion. First, the court pointed out that a subtle hazards analysis had never by itself caused the Supreme Court to hold that Glass-Steagall prohibited a practice. The analysis of the hazards in previous cases, the *Bankers Trust II* court stated, simply reinforced the interpretation that Glass-Steagall proscribed or permitted a particular practice.[160] Second, the court noted, the Supreme Court concluded that subtle hazards indicated prohibition of a banking practice only when such a practice gave rise to each of the hazards. Third, stated the court, so long as a bank avoided a hazard "to a large extent," the practice may be permitted.[161] Finally, the court viewed the subtle hazards analysis as an instance of the principle

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[152] *Id.* at 160 n.12.
[153] 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 107 S. Ct. 3228, 3228 (1987).
[154] *Id.* at 1055.
[155] *Id.*
[156] *Id.* at 1069.
[157] *Id.*
[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] *Id.*

that requires deference to an agency's reasonable construction of its statute's ambiguities.[162]

The legislative history and the cases interpreting Glass-Steagall demonstrate that Congress, reacting to the financial crisis surrounding the Depression, viewed commercial banking ventures in securities as inherently dangerous to banks and the banking system. Through the years, there has been debate over how restrictive regulation should be regarding commercial banking securities activities. The controversy escalated as banks sought new methods of undertaking permissible investment-related activities.[163] Congress responded to the situation with deregulatory legislation intended to maintain competitiveness among the various types of financial institutions.[164]

Deregulation decreased some of the traditional barriers that divided banking institutions from non-banking entities.[165] In 1980, the Depository Institutions Deregulation and Monetary Control Act broadened the deregulatory foundation of commercial banks and thrifts.[166] In 1982, the Garn-St. Germain Depository Institutions Act accelerated the process of deregulation.[167] The draft form contained provisions that would loosen Glass-Steagall's prohibitions, but the final bill dispensed with such provisions and focused on helping troubled institutions.[168]

As Congress ponders changes in the regulatory structure of banking, it faces the problem of how to enhance the competitive

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[162] *Id.* See Chevron U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837 (1984) for an enunciation of deference principles. The Court stated:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

Id. at 842–43.

[163] *See* Phelps & Spedale, *supra* note 44, at 17.

[164] *See* Norton, *The 1982 Banking Act and the Deregulation Scheme*, 38 Bus. Law. 1627, 1627 (1983).

[165] *Id.* at 1627–28.

[166] *Id.* at 1628.

[167] *Id.* at 1630.

[168] *Id.*

position of commercial banks while maintaining a safe and sound system.[169] The Glass-Steagall wall, though over fifty years old, is still hotly debated.[170] In the midst of the controversy came *Securities Industry Association v. Board of Governors* (*NatWest*), an opinion that should serve to increase the fever of debate.[171] In analyzing the *NatWest* decision, one should be cognizant of how Congress and previous courts grappled with the banking policies of safety and soundness and competition.

II. *NatWest* Court's Interpretation of Glass-Steagall and the Role of the Subtle Hazards Analysis

The issue before the District of Columbia Court of Appeals was whether the Board reasonably concluded that the combination of securities brokerage and investment advice by a member bank's affiliate did not violate section 20 of Glass-Steagall, which prohibits the "public sale" of securities by a deposit-taking institution.[172] The court held that the Board reasonably interpreted Glass-Steagall and correctly followed precedent.[173] The *NatWest* court, therefore, denied the petition for review of the Board's order.[174]

The petition came before the court of appeals following the Board's approval of NatWest's[175] 1985 application.[176] NatWest submitted its application pursuant to section 4(c)(8) of BHCA, which is an exception to the general prohibition of ownership or control by a bank of a non-bank company.[177] NatWest proposed to offer

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169 *See* Norton, *supra* note 3, at 329.

170 Congressional reform measures again failed to produce a final enactment in 1988. *See House Rules Will Not Consider Banking Industry Reform Bill*, [July–Dec.] Banking Rep. (BNA) No. 51, at 647. House Speaker Jim Wright, upon realizing that the House would not approve the reform bill, sent a letter to Federal Reserve Board Chairman Bud Greenspan stating that "we will take care of this matter in the legislative process." *Id.*

The stock market crash of October 1987 may have impacted on the Congress's failure in that year to pass legislation amending or repealing Glass-Steagall. *See* Bradley, *Banks in No Danger, But Their Push for New Powers May Be*, Christian Sci. Monitor, Oct. 21, 1987, at 32, col. 4.

171 Securities Indus. Ass'n v. Board of Governors (NatWest), 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 108 S.Ct. 697 (1988).

172 *Id.* at 811.

173 *Id.*

174 *Id.*

175 "NatWest" refers to National Westminster, Bank PLC and its subsidiary, NatWest Holdings, Inc.

176 *See* 821 F.2d at 811–12 nn.3–4.

177 *Id.* at 811.

discount brokerage and investment advice through County Services Corporation (CSC), a newly formed subsidiary.[178]

As outlined by NatWest, CSC's buying and selling of securities would be done solely as an agent.[179] CSC would not have discretion over customer accounts and would act only upon customer request.[180] NatWest further provided that CSC would not act as a principal or underwriter, and would not bear any financial risk for securities it brokered or recommended.[181] According to the application, CSC would receive compensation for the volume of transactions it carried out for its customers. NatWest also provided that it would not share depositor lists or confidential information with CSC. NatWest and CSC, stated the application, would maintain separate books, records, assets and liabilities.[182]

Based in part upon the commitments NatWest set forth in its application, the Board approved the institution's proposals in an order dated June 13, 1986.[183] The Board determined that CSC's proposed activities were "closely related" to banking and that the activities were a "proper incident"[184] to banking within section

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[178] *Id.*

[179] *Id.*

[180] *Id.* at 811–12.

[181] *Id.* at 812.

[182] *Id.*

[183] *National Westminster Bank PLC*, 72 Fed. Res. Bull. 584, 595 (1986) [hereinafter *National Westminster*]. While NatWest's application was pending, the Board elicited commitments from NatWest regarding its relationship with CSC's proposed activities. Those commitments included the following:

> The Subsidiary will not transmit its investment advisory research or recommendations to the commercial lending department of any member of the NatWest group . . . . In any brokerage transaction performed by the Subsidiary where the counterparty (as principal) is a member of the NatWest group, NatWest will disclose this fact to the brokerage customer and obtain specific consent from the customer for such transaction . . . . No director of the Subsidiary will also be a director of either NatWest PLC, National Westminster Bank USA, N.A. . . . or any subsidiary of NatWest USA . . . . No officer of the Subsidiary will also serve as an officer of either NatWest PLC, NatWest USA or any subsidiary of NatWest USA. In addition, no officer of the Subsidiary engaged in providing investment advisory or securities brokerage services will also provide such services for, on behalf of or with respect to any other member of the NatWest group. As noted in the Application. . . the Subsidiary will be maintained, and will hold itself out to the public, as a separate and distinct corporate entity, and will conduct its business separate from the other members of the NatWest group . . . . The Subsidiary will not refer its customers who desire to purchase securities on credit to any Affiliate . . . . [citations omitted]

NatWest, 821 F.2d at 812 n.4.

[184] *See supra* note 125.

4(c)(8) of BHCA.[185] The Board also determined that CSC's proposed activities were not proscribed by Glass-Steagall because the combination of discount brokerage and investment advice was not a "public sale" of securities under section 20 of that act.[186]

SIA petitioned the court of appeals to review the Board's order, arguing that CSC's proposed activities were within Glass-Steagall's literal terms.[187] SIA also claimed that the activities implicated the subtle hazards that the Supreme Court enunciated in *Camp*.[188] SIA did not challenge the Board's finding that NatWest's proposal met the "closely related" and "proper incident" tests in accordance with BHCA standards.[189]

The *NatWest* court, in upholding the Board's decision and permitting a bank's affiliate to offer brokerage and investment advice, divided its reasoning into two main components. First, the court considered whether NatWest's proposal violated section 20 of Glass-Steagall because brokerage and investment advice combined amounted to a "public sale" of securities.[190] Second, the court applied the subtle hazards analysis to NatWest's contemplated activities.[191]

As a preliminary matter the court reasoned that, because the Board comprehensively reviewed Glass-Steagall's section 20 and provided a detailed explanation for its findings, the decision was entitled to "substantial deference"[192] on review.[193] The court stated that, because Congress has not addressed the specific issue involved in *NatWest*, the Board's interpretation was required to stand if it was a "reasonable construction" of Glass-Steagall.[194]

The court first dealt with the question of whether investment advice combined with brokerage was prohibited by the literal meaning of the term "public sale" in section 20 of Glass-Steagall.[195] Section 20 prohibits member banks from affiliating with a corporation "engaged principally in the issue, flotation, underwriting, public

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185 *National Westminster*, *supra* note 202, at 584–91.

186 *Id.* at 592.

187 *See NatWest*, 821 F.2d at 813–15.

188 *Id.* at 815–19.

189 *Id.* at 812–13.

190 *Id.* at 813–15.

191 *Id.* at 815–19.

192 See *supra* note 162 and accompanying text for the Supreme Court's enunciation of the level of deference to be accorded administrative agencies.

193 *NatWest*, 821 F.2d at 813.

194 *Id.*

195 *Id.*

sale or distribution" of securities.[196] The *NatWest* court principally relied upon the Supreme Court rulings in *Schwab* and *ICI* in determining section 20's applicability to the NatWest proposal. The court noted that the *Schwab* Court ruled that discount brokerage did not fall within the term "public sale" for Glass-Steagall purposes.[197] The court followed *Schwab* because it found NatWest's proposed activities similar to Schwab's brokerage services.[198]

The *NatWest* court then cited *ICI* for the proposition that Glass-Steagall did not prohibit a bank's affiliate from offering investment advice.[199] The court compared NatWest's proposed activities to those at issue in *ICI*, and held that both situations involved entities providing services on behalf of customers rather than for the account of the financial institution.[200] Though *ICI* dealt with a section 21 Glass-Steagall question, the *NatWest* court found the holding equally applicable to the facts before it.[201] Thus, concluded the court, NatWest's proposal to offer investment advice was an act already permitted by the Supreme Court.

Having found that Supreme Court precedent allowed banks to undertake the securities-related activities of brokerage and investment advice, the *NatWest* court reasoned that the only question remaining was whether the combination of these activities brought them under Glass-Steagall's section 20 prohibition against public sales of securities.[202] The court stated that the Board reasonably interpreted the term "public sale" in respect to the NatWest proposal.[203] The court stated that CSC would not act as a principal in buying and selling securities. The court also noted that CSC would not make a market in securities with its own funds, nor would it act as an agent for issuers. In sum, the *NatWest* court did not see the addition of investment advice to brokerage services as implicating any of the activities the *Schwab* Court described as being typically associated with underwriting.[204] Though the court stated that investment advice might be a common attribute of underwriters, this did not transform CSC's activities into ones proscribed by section

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[196] 12 U.S.C. § 377.
[197] *NatWest*, 821 F.2d at 813.
[198] *Id.* at 814.
[199] *Id.* at 813.
[200] *See id.* at 813–14.
[201] *Id.* at 814 n.6.
[202] *Id.* at 814.
[203] *Id.*
[204] *Id.*

20.[205] The court also maintained that banks traditionally managed investments in a fiduciary capacity, and that Glass-Steagall, therefore, could not have been intended to prohibit such a time-honored function.[206]

After refuting SIA's public sale arguments, the court addressed the subtle hazards issue.[207] First, however, the *NatWest* court noted that a subtle hazards analysis might not be necessary where the activities were not found to fall within Glass-Steagall's literal terms.[208] The court also believed that because CSC did not hold and sell particular investments, the subtle hazards analysis was not required.[209] Nevertheless, as it did in *Bankers Trust II*, the court analyzed the hazards.[210]

In its subtle hazards analysis, the *NatWest* court once again looked to *Schwab* for guidance.[211] *Schwab*, asserted the court, reaffirmed *Camp's* finding that Congress intended to prevent the subtle hazards that arise when commercial banks venture into securities activities.[212] According to the *NatWest* court, however, the *Schwab* Court had limited *Camp*'s holding by concluding that all of the subtle hazards Congress identified were attributable to the "promotional pressures" that result from affiliation with entities that purchase and sell investments on their own account.[213]

According to the *NatWest* court, CSC, like Schwab, did not have a "salesman's stake" in particular securities.[214] Thus, because the combination of investment advice with brokerage did not increase

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[205] *Id.*

[206] *Id.* at 814–15.

[207] *Id.* at 815.

[208] *Id.* at 816 n.8.

[209] *Id.* at 816.

[210] *Id.* at 815–19. *See* Securities Indus. Ass'n v. Board of Governors (*Bankers Trust II*), 807 F.2d 1052, 1066–67 (D.C. Cir. 1986). The court stated:

> Although the language and the history of the specific provisions support the reasonableness of the Board's construction of those provisions, the Board might nonetheless be obligated to adopt a different construction if the background policies of the Act as interpreted by the Supreme Court in cases like *Camp* . . . conflict with that construction . . . . But the Supreme Court's Glass-Steagall Act cases uniformly consider "subtle hazards" and examine background purposes of the Act. Until the Court indicates that it no longer employs this analysis to interpret the Glass-Steagall Act, we, too, must take such considerations into account.

Id.

[211] *NatWest*, 821 F.2d at 817.

[212] *Id.* at 816.

[213] *Id.*

[214] *Id.* at 817.

the pressure to promote particular securities, NatWest's proposal did not implicate any subtle hazards.[215] The court added that the Board, in determining that the combination of investment advice and discount brokerage did not give rise to subtle hazards, acted within its discretion in considering the "realities" of the industry and the "commitments" made by NatWest.[216]

The *NatWest* court concluded that NatWest's proposal to offer discount brokerage and investment advisory services through an affiliate was permitted by Glass-Steagall.[217] The court relied in part upon principles of judicial deference to administrative interpretations of statutes.[218] The court determined that the Board reasonably interpreted the term "public sale" as it applied to NatWest's proposal. The court then found reasonable the Board's assertion that NatWest's proposed activities would not implicate the subtle hazards that Congress sought to prevent through enacting Glass-Steagall.

III. Analysis of the *NatWest* Opinion

The *NatWest* court's decision to permit a bank's affiliate to provide both discount brokerage and investment advice represents a potentially dangerous choice between competing bank policies. Although the Supreme Court in *Camp* pointed out the significance of the subtle hazards Congress intended to prevent with Glass-Steagall, the *NatWest* court doubted and deflated the importance of such an analysis. In doing so, the court incorrectly deemphasized the safety and soundness concerns underlying the subtle hazards analysis. Thus, the court implicitly elevated the policy of furthering competition to a higher plateau than the policy of safety and soundness. Such a policy choice jeopardizes the stability of the banking system.

The *NatWest* opinion utilized a two-part test to determine whether the proposed activities violated Glass-Steagall. First, the court decided that NatWest's proposal to provide combined discount brokerage and investment advice through an affiliate did not fall within Glass-Steagall's literal prohibitions. Second, the court determined that NatWest's proposal did not conflict with Congress's intent that Glass-Steagall prevent the subtle hazards that arise when banks participate in the securities field. The court's reasoning in

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215 *Id.*
216 *See supra* note 176 and accompanying text.
217 *NatWest*, 821 F.2d at 818.
218 *See id.* at 820.

part one of the test was sound. Supreme Court precedent clearly supported the reasonableness of the position that NatWest's plans did not violate Glass-Steagall's literal terms.[219] The second component of the opinion, the subtle hazards analysis, presented the court with stronger challenges to NatWest's activities.

NatWest's plans to offer combined discount brokerage and investment advice withstood the subtle hazards scrutiny for three main reasons. First, the court displayed reluctance even to consider the analysis.[220] Second, the court disregarded some apparent hazards.[221] Third, the court accorded great weight to the Board's determinations.[222]

The *NatWest* court first questioned whether a subtle hazards analysis was necessary where the activities were not found to fall within Glass-Steagall's literal terms.[223] The District of Columbia circuit's reluctance to consider subtle hazards, first displayed in *Bankers Trust II*[224] and echoed in *NatWest*, indicates that it misunderstood the significance of such an analysis. The Supreme Court developed the subtle hazards analysis after examining Glass-Steagall's legislative history.[225] Congress enacted Glass-Steagall to prevent the subtle hazards caused by commercial bank crossover into securities activities, hazards that erupted into outright abuses prior to the Depression.[226] The essence of Glass-Steagall is the promotion of the safety and soundness of commercial banks by limiting their securities activities.[227] The subtle hazards analysis ensures that courts will examine congressional intent, and reminds courts of the financial events that surrounded Glass-Steagall's enactment. The *NatWest* court advocated an approach to Glass-Steagall interpretation that would make the literal meaning component of the test a threshold concern. Thus, if an activity did not violate the literal terms of the statute, the subtle hazards analysis would be unnecessary. Such an approach is unwarranted because the Supreme Court devised, and

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[219] See *supra* notes 123–43 and accompanying text for a discussion of precedent that the *NatWest* court relied upon to determine that NatWest's proposed activities did not fall within Glass-Steagall's literal prohibition against the "public sale" of securities.

[220] *See infra* notes 224–38 and accompanying text.

[221] *See infra* notes 239–44 and accompanying text.

[222] *See infra* notes 245–47 and accompanying text.

[223] *See supra* note 189 and accompanying text.

[224] *See supra* note 174 and accompanying text.

[225] *See supra* notes 8–10 and accompanying text.

[226] *See supra* notes 56–62, 69–73 and accompanying text.

[227] *See supra* note 8 and accompanying text.

has regularly employed, the subtle hazards analysis in Glass-Steagall cases.[228]

The *NatWest* court's hesitance to perform a subtle hazards analysis demonstrated an insensitivity to the changing face of the financial services industry.[229] Glass-Steagall is over fifty years old, and the banking industry has been altered in that time. Thus, it is imperative in interpreting Glass-Steagall to look beyond the plain meaning of its terms because there are activities and institutions that now exist that Congress did not contemplate in 1933. Discount brokerage, for example, was not practiced at the time Congress passed Glass-Steagall.[230] Though banks did offer full-service brokerage prior to 1933, it is difficult to determine the scope of such activities.[231] Glass-Steagall's legislative history shows that Congress did not fully discuss the extent to which brokerage services implicated the risks associated with securities activities.[232] Therefore, as courts and regulators pass upon the acceptability of a securities-related practice, it is essential that they consider broad congressional purpose in enacting Glass-Steagall.

The *NatWest* court, in its desire to shelve the subtle hazards analysis, disregarded traditional Supreme Court concern for safety and soundness of commercial banks. In the seminal *Camp* decision, the Court noted that Congress believed preventing risks associated with investment banking outweighed the favorable competitive consequences that might stem from commercial bank involvement in securities.[233] If courts eliminated the subtle hazards analysis from their treatment of Glass-Steagall cases, it would pave the way for commercial banks wishing to cross the line into risky securities activities. Banks would only have the task of convincing the court that the literal terms of Glass-Steagall did not apply to their proposed activities. Unless the court broadly applied Glass-Steagall's terms, new forms of securities activities not contemplated by Congress could be approved, possibly in circumvention of legislative intent. Removing the subtle hazards barrier would thus further the deregulatory aim of improving the competitive position of commercial banks.[234]

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[228] *See supra* note 210 and accompanying text.
[229] *See supra* notes 38–45 and accompanying text.
[230] *See* Note, *supra* note 51, at 1498.
[231] *Id.* at 1512–13 n.49.
[232] *Id.* at 1512.
[233] *See supra* note 10 and accompanying text.
[234] *See supra* note 152 and accompanying text.

Though the *NatWest* court did not explicitly discuss policy rationales, one can infer that the court favored the policy of competition over safety and soundness. Because Glass-Steagall cases traditionally consider the policies involved, it is fair to assume that the *NatWest* court was mindful of policy considerations. The *NatWest* decision, combined with subsequent regulatory and judicial disregard for subtle hazards, would increase commercial bank competitiveness with investment banks. Unfortunately, such increased competitiveness would be at the expense of the safety and soundness of the system.

The court was correct if, indeed, it recognized that allowing commercial banks to compete profitably is an important aspect of bank regulation. As most high quality corporate customers are now served by investment bankers, commercial banks are left with poor quality loans.[235] As commercial bank profitability declines, the banking system grows weaker.[236] Therefore, to enable commercial banks to compete for high quality customers, it might be healthy for the banking system for regulators and the courts to grant banks more latitude in the securities field.

Clearly, there are arguments to be made for tearing down the Glass-Steagall wall, or at least loosening its restrictions. The advantages for the United States economy resulting from such reform might outweigh possible threats to bank safety and soundness. But Congress, rather than the courts, should be responsible for making such determinations of public policy. Congress's conclusion that the safety and soundness of the banking system would be best served by separating commercial from investment banking, though over fifty years old, remains embodied in Glass-Steagall. Congress has had subsequent opportunities to diminish or abolish the distinctions between commercial and investment banks. In light of the profound changes that the years have wrought in the financial services industry, Congress's failure to enact a comprehensive reform package is, perhaps, inexcusable. But such failure does not vest regulators and judges with power to fashion new legislation and policy decisions.

The *NatWest* court, in its subtle hazards analysis, failed to discover some apparent dangers in the proposal to combine investment advice and discount brokerage. The court asserted that an affiliate whose profits depended solely upon the volume of shares it traded

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[235] *See* Clarke, *The Limits of Bank Regulation*, 6 ANN. REV. BANKING L. 227, 230 (1987).
[236] *Id.*

would not have a promotional interest in particular securities.[237] This assertion is correct with regard to *Schwab*, in which the affiliate offered only brokerage services.[238] Where an affiliate also advises customers as to which securities to purchase, however, the court's reasoning does not hold together. For example, if a corporate customer came to CSC, which advised that customer to purchase a certain security, and then CSC brokered shares of the security to the customer, CSC and NatWest would, naturally, hope that the security fared well. The common business goal of customer satisfaction might, therefore, give rise to the subtle hazards Congress intended Glass-Steagall to prevent.[239]

Where institutional customers[240] are involved, as was the case in NatWest's proposal, securities transactions would likely involve large sums of money. Thus, with such high stakes involved for those who invest through CSC, NatWest's reputation would be on the line. Even though the NatWest scheme provided for the bank and its affiliate to be distinct entities,[241] sophisticated business customers would be likely to know the connection between the two firms. Further, because of the possible high stakes involved in CSC transactions, the potential for media exposure of securities abuses would be great, thus endangering public confidence in NatWest's banking activities.

That NatWest and CSC would be linked in the public mind could prove dangerous in financially difficult times. Affiliates find it hard, generally, to maintain separateness in times of stress.[242] This difficulty results from the marketplace's habit of attributing the problems of one part of a financial entity to the entity as a whole.[243] Thus, in order to save its reputation, NatWest might employ unsafe or unsound methods of the type detailed in *Camp*. Because Glass-Steagall is a prophylactic measure, and because the securities market is so volatile, the *NatWest* court should have perceived the potential dangers and reversed the Board's decision to allow brokerage and investment advice under one roof.

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[237] *See supra* notes 201–16 and accompanying text.

[238] *See supra* notes 130–43 and accompanying text.

[239] *See supra* notes 102–22 and accompanying text.

[240] NatWest sought approval to provide services to banks, insurance companies, corporations, health plans, or natural persons with assets exceeding five million dollars. Securities Indus. Ass'n v. Board of Governors (NatWest), 821 F.2d 810, 811 n.3 (D.C. Cir. 1987).

[241] *See id.* at 812.

[242] 72 FED. RES. BANK OF N.Y. ANN. REP. 25 (1986).

[243] *Id.*

The *NatWest* court was also incorrect in attaching such great weight to the Board's determination that subtle hazards were not implicated because of the "realities" of the brokerage industry and the "commitments" NatWest made regarding its activities.[244] By relying upon NatWest's commitments, the Board was circumventing congressional intent in passing Glass-Steagall. SIA's point was well-taken that the Board should not be allowed to transform the broad prohibitions contained in Glass-Steagall into a network of administrative regulation.[245] Further, the Board's express reliance on numerous promises by NatWest suggests that the Board recognized the inherent dangers that combined investment advice and discount brokerage would implicate. The Board's commitment-based approval of NatWest's plan would necessitate close supervision once CSC began operations. If the Board continues to make commitment dependent approvals, and the courts uphold such decisions,[246] then the supervisory and enforcement roles of regulators must increase to ensure compliance. As it now stands, regulatory monitoring is not capable of maintaining safety and soundness as the courts and regulators allow further erosion of Glass-Steagall.[247] As commercial banks make more inroads into securities, regulatory agencies should increase staff sizes and, as a deterrent, impose tougher sanctions on those banks that abuse their ability to have securities affiliates.

The *NatWest* opinion, though correct in its examination of Glass-Steagall's literal meaning, was deficient in policy analysis, and thus wrong in its outcome. The court was hesitant even to consider congressional purpose as reflected in the subtle hazards. When the

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[244] *See supra* note 218 and accompanying text.

[245] *NatWest*, 821 F.2d at 818.

[246] *See, e.g.*, Securities Indus. Ass'n v. Board of Governors, 847 F.2d 890 (D.C. Cir. 1988). The court held that a commercial bank's affiliate may engage in underwriting and dealing in commercial paper. The court maintained that the Board reasonably interpreted Glass-Steagall to permit banks to have affiliates whose underwriting activities were "regular" or "integral," but not "substantial." *Id.* at 893. One of the reasons that the court noted for permitting such an affiliation was that the Board's order contained limitations on loans and investment advice to issuers whose paper the affiliate underwrites. *Id.* at 899.

[247] *See* DiLorenzo, *supra* note 12, at 686–89. DiLorenzo contended that:

> A regulatory approach could exist within a legislative framework that limits the type or size of transactions between the underwriting subsidiary or affiliate and the bank, or an approach that bans any such transactions. The nature of regulatory monitoring, and the available evidence of its usefulness, indicate that such regulation is inherently incapable of uncovering or avoiding potential hazards, inherently impotent to correct hazards once uncovered, and counter-productive in effect.

Id. at 687.

court did examine the subtle hazards, it overlooked the significant dangers that can arise when financial affiliates are linked in the public mind. The court's reliance on the commitments the Board extracted from NatWest represented a willingness to circumvent congressional intent and an insensitivity to the dynamics of bank supervision. If future courts adopt the *NatWest* posture, safety and soundness in the banking industry would diminish.

Conclusion

The United States Court of Appeals for the District of Columbia Circuit, in *Securities Industry Association v. Board of Governors* (*NatWest*), held that a bank's affiliate could, without violating Glass-Steagall's prohibitions on bank involvement in securities, offer both discount brokerage and investment advice. The opinion represented a determination by the court that the policy of maintaining a safe and sound banking system was not as significant as when Congress enacted Glass-Steagall.

Although over fifty years have passed since Congress enacted Glass-Steagall, the importance of maintaining a safe and sound banking system has not lessened. The recent volatility of the stock market and the mounting problems with the savings and loan industry demonstrate that Congress must remain cautious when determining the extent to which commercial banks should be permitted to engage in securities activities. Congress should act soon with a comprehensive reform package that clarifies the boundaries, if any, that should exist between commercial and investment banking. It is no longer clear that a sharp division ought to exist. On the other hand, it remains clear that, because public confidence is so vital for the banking system to survive, the safety and soundness policy must be the primary consideration in reform efforts. Implicit in such a policy recognition is the notion that any loosening of Glass-Steagall restrictions should be accompanied by increased funding and staffing for supervisory agencies. Until Congress does enact new legislation, the judiciary and regulators should divine and implement the policy choices Congress made in 1933 rather than furthering their own policy agendas.

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